Initial Statement of Reasons for

Proposed Adoption of California Code of Regulations,

Title 18, Section 1525.4, *Manufacturing and Research & Development Equipment*

SPECIFIC PURPOSES, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFITS

Current Law

As a general matter, California's Sales and Use Tax Law (Rev. & Tax. Code (RTC), div. 2, pt. 1, chs. 1-11 (§ 6001 et. seq.)) imposes sales tax on retailers, and the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless an exemption or exclusion applies. (RTC, §§ 6012, 6051.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers if their contracts of sale so provide. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700.)

When sales tax does not apply, California use tax generally applies to the use of tangible personal property purchased from a retailer for storage, use or other consumption in California. (RTC, §§ 6011, 6201.) Unless an exemption or exclusion applies, the use tax is measured by the sales price of tangible personal property and the person actually storing, using, or otherwise consuming the tangible personal property is liable for the tax. (RTC, §§ 6011, 6201, 6202, 6401; Cal. Code Regs., tit. 18, § 1685.) However, every retailer "engaged in business" in California that makes sales subject to California use tax is required to collect the use tax from its customers and remit it to the State Board of Equalization (Board), and such retailers are liable for California use tax that they fail to collect from their customers and remit to the Board. (RTC, §§ 6202, 6203; Cal. Code Regs., tit. 18, §§ 1684, 1686.)

The measure of tax is generally the same regardless of whether the applicable tax is a sales tax imposed on the retailer, or a use tax imposed on the purchaser. (See RTC, §§ 6011, 6012.) The current statewide sales and use tax rate is 7.50 percent, although the combined tax rate is higher in cities and counties that impose additional district transactions (sales) and use taxes in conformity with the Transactions and Use Tax Law (RTC, § 7251 et seq.). The 7.50 percent rate is comprised of:

- The .50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Public Safety Fund by section 35 of article XIII of the California Constitution;
- The .25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Education Protection Account by section 36 of article XIII of the California Constitution;

- The 3.6875 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are deposited in the state's general fund;
- The 0.50 percent rate of the sales and use taxes imposed and required to be deposited in the state's Local Revenue Fund by RTC sections 6051.2 and 6201.2;
- The 0.25 percent rate of the sales and use taxes imposed by RTC sections 6051.3 and 6201.3 that are deposited in the state's general fund;
- The 0.25 percent rate of the sales and use taxes imposed and required to be deposited in the state's Fiscal Recovery Fund by RTC sections 6051.5 and 6201.5;
- The 1.0625 percent rate of the sales and use taxes imposed by RTC sections 6051 and 6201 that are required to be deposited in the state's Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15; and
- The 1.00 percent rate specified by RTC section 7203.1 for local sales and use taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law (RTC, § 7200 et seq.).

RTC section 6377.1 was enacted by Assembly Bill No. (AB) 93 (Stats. 2013, ch. 69, effective July 11, 2013), and amended by Senate Bill No. (SB) 90 (Stats. 2013, ch. 70, effective July 11, 2013). RTC section 6377.1, subdivision (a), provides a partial exemption from sales and use tax on certain sales and purchase made on and after July 1, 2014, and before July 1, 2022. The partial exemption applies to: (1) qualified tangible personal property purchased by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of tangible personal property, including packaging if required; (2) qualified tangible personal property purchased for use by a qualified person to be used primarily in research and development; (3) qualified tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any qualified tangible personal property described under (1) or (2) above; and (4) qualified tangible personal property purchased for use by a contractor purchasing that property for use in the performance of a construction contract for a qualified person that will use that property for statutorily specified purposes.

RTC section 6377.1, subdivision (b), defines relevant terms used in subdivision (a), including "fabricating," "manufacturing," "primarily," "process," "processing," "qualified person," "qualified tangible personal property," "refining," "research and development," and "useful life." As relevant here, RTC section 6377.1, subdivision (b)(3), provides that "'Primarily' means 50 percent or more of the time. RTC section 6377.1, subdivision (b)(6) provides that:

> (A) "Qualified person" means a person that is primarily engaged in those lines of business described in Codes 3111 to 3399, inclusive, 541711, or 541712 of the North American Industry Classification System (NAICS) published by the United States Office of Management and Budget (OMB), 2012 edition.
> (B) Notwithstanding subparagraph (A), "qualified person" shall not include either of the following:

> (i) An apportioning trade or business that is required to apportion its business income pursuant to subdivision (b) of Section 25128.
> (ii) A trade or business conducted wholly within this state that would be required to apportion its business income pursuant to subdivision (b) of Section 25128 if it were subject to apportionment pursuant to Section 25101.

And, RTC section 6377.1, subdivision (b)(7)(A)(iv) provides that qualified tangible personal property includes "Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or that constitute a research or storage facility used during those processes. Buildings used solely for warehousing purposes after completion of those processes are not included."

RTC section 6377.1, subdivision (c), provides that the partial exemption shall not be allowed, unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the Board may prescribe, and the retailer retains the exemption certificate in its records and furnishes it to the Board upon request.

RTC section 6377.1, subdivision (d), specifies that the partial exemption does not apply to any local sales and use taxes levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or district transactions and use taxes levied pursuant to the Transactions and Use Tax Law. Subdivision (d) also specifies that the partial exemption does not apply to any sales and use taxes levied pursuant to RTC sections 6051.2, 6051.5, 6201.2, and 6201.5, any sales and use taxes levied pursuant to section 35 of article XIII of the California Constitution, and any sales and use taxes levied pursuant to RTC sections 6051 and 6201 that are required to be deposited in the Local Revenue Fund 2011 by RTC sections 6051.15 and 6201.15. Therefore, the partial exemption applies to the state general fund taxes imposed by RTC sections 6051, 6051.3, 6201, and 6201.3, and the state's Education Protection Account tax imposed by section 36 of article XIII of the California Constitution. Accordingly, from July 1, 2014, to December 31, 2016, the partial exemption rate is 4.1875 percent. After the state's Education Protection Account tax expires on December 31, 2016, the partial exemption rate will be 3.9375 percent.

RTC section 6377.1, subdivision (e)(1)(A), provides that the partial exemption shall not apply to "[a]ny tangible personal property purchased during any calendar year that exceeds two hundred million dollars ($200,000,000) of purchases of qualified tangible personal property for which an exemption is claimed by a qualified person under this section." It also provides that "in the case of a qualified person that is required to be included in a combined report under Section 25101 or authorized to be included in a combined report under Section 25101.15, the aggregate of all purchases of qualified personal property for which an exemption is claimed pursuant to this section by all persons that are required or authorized to be included in a combined report shall not exceed two hundred million dollars ($200,000,000) in any calendar year."

RTC section 6377.1, subdivision (f), provides that the partial exemption applies to leases which are classified as continuing sales and continuing purchases for purposes of the sales and use tax law. California Code of Regulations, title 18, section (Regulation) 1660, *Leases of Tangible Personal Property - In General*, prescribes the general application of sales and use tax to leases.

The partial exemption expires on July 1, 2022, in accordance with RTC section 6377.1, subdivision (a). And, RTC section 6377.1 is repealed by its own terms effective January 1, 2023, per RTC section 6377.1, subdivision (h).

RTC section 6377.1 is substantially, but not entirely, modeled after the partial sales and use tax exemption provided by RTC section 6377 (repealed by its own terms January 1, 2004) and interpreted in Regulation 1525.2, *Manufacturing Equipment*. For purchases made from January 1, 1994, through December 31, 2003, RTC section 6377 generally provided a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in the manufacturing, processing, refining, fabricating, or recycling of property, or research and development. In addition, RTC section 6377, subdivision (b)(3), provided that "'Primarily' means tangible personal property used 50 percent or more of the time in an activity described in subdivision (a)." RTC section 6377, subdivision (b)(6)(B), required a "qualified person" to be "engaged in those lines business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual" 1987 edition, published by the OMB. And, RTC section 6377, subdivision (c), provided that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1525.2, subdivision (c)(6)(B), explained that:

- "For purposes of classifying a line or lines of business [under RTC section 6377, subdivision (b)(6)(B)], the economic unit shall be the 'establishment' and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production"; and
- "Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting."

Regulation 1525.2 also prescribed the form of the exemption certificate required by RTC section 6377, provided a sample "section 6377" exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6377" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

To a lesser extent, RTC section 6377.1 was also modeled after provisions in RTC section 6378 and interpreted in Regulation 1532, *Teleproduction or Other Postproduction Service Equipment*. As relevant here, RTC section 6378 currently provides a partial exemption from sales and use tax for tangible personal property purchased for use by a qualified person to be used primarily in teleproduction and other postproduction services. In addition, RTC section 6378, subdivision (c)(1) provides that "primarily" means "tangible personal property used 50 percent or more of the time in" a qualified activity. RTC section 6378, subdivision (c)(2) provides that "qualified person" means "any person that is primarily engaged in teleproduction or other postproduction activities that are described in Code 512191 of the" NAICS, 1997 edition. And, RTC section 6378, subdivision (d), provides that "No exemption shall be allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes the board with a copy of the exemption certificate."

Furthermore, as relevant here, Regulation 1532, subdivision (c)(2), explains that:

- "For purposes of classifying a line of business [under RTC section 6378, subdivision (c)(2)], the economic unit shall be the 'establishment' and the classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues";
- "'Primarily engaged' means 50 percent or more of gross revenues, including intra-company charges, are derived from teleproduction or other postproduction activities for the financial year of the purchaser preceding the purchase of the property. In cases where the purchaser was not primarily engaged in 'teleproduction or other postproduction services' for the financial year preceding the purchase of the property, the one year period following the date of purchase of the property will be used"; and
- "In the case of a nonprofit teleproduction or other postproduction establishment, 'primarily engaged' means 50 percent or more of the funds allocated to the establishment are attributable to teleproduction or other postproduction services.

Regulation 1532 also prescribed the form of the exemption certificate required by RTC section 6378, provided two sample "section 6378" exemption certificates, including a blanket exemption certificate, and prescribed the circumstances under which a seller may accept a "section 6378" exemption certificate in good faith for purposes of being relieved of the obligation to pay or collect tax.

Proposed Regulation

There is currently no regulation that specifically implements, interprets, or makes specific the partial exemption from sales and use tax established by RTC section 6377.1. There is currently no regulation that prescribes the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, or provides a sample partial exemption certificate. Also, there is no regulation that specifically prescribes the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser.

In addition, there is currently no regulation that defines what is meant by the phrase "primarily engaged" in a qualifying line of business for purposes of RTC section 6377.1, subdivision (b)(6). There is currently no regulation that clarifies and explains the meaning of the phrase "special purpose buildings and foundations" as used in RTC section 6377.1, subdivision (b)(7)(A)(iv). There is currently no regulation that clarifies and explains how the partial exemption applies in the context of lease transactions. And, there is currently no regulation that clarifies how the partial exemption applies in the context of construction contracts.

Business Taxes Committee Process

Board staff determined that it was necessary to draft proposed Regulation 1525.4 to have the effect and accomplish the objectives of fully implementing, interpreting, and making specific the provisions of RTC section 6377.1 and specifically addressing the issues (or "problems" within the meaning of Gov. Code, § 11346.2, subdivision (b)(1)) identified above. Therefore, Board staff prepared a draft of the regulation and held its first meeting to discuss the draft with interested parties on October 9, 2013.

At the October 9, 2013, meeting, staff responded to written comments received prior to the meeting, as well as other suggestions to clarify the draft regulation, including expanding upon the definitions provided in RTC section 6377.1, clarifying the phrase "primarily engaged," clarifying how tax applies to testing equipment and manufacturing aids, allowing for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, providing a separate partial exemption certificate for construction contractors to use, and clarifying the application of the $200 million annual cap. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of proposed Regulation 1525.4 and, on November 14, 2013, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the October 9, 2013, meeting and to the interested parties that submitted written comments regarding the initial draft of the proposed regulation.

Board staff held a second meeting with interested parties on December 5, 2013, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, as well as other suggestions to clarify the definition of "qualified person," clarify when a purchaser is "primarily engaged" in a qualifying line of business, clarify how the partial exemption applies in the context of construction contracts, including contracts for special purpose buildings and foundations, and make various other minor revisions or edits. Then, staff incorporated the suggestions discussed at the meeting into a revised draft of the proposed regulation and, on January 31, 2014, staff posted the revised draft of the proposed regulation on the Board's website, and distributed the revised draft of the proposed regulation to the interested parties that attended the December 5, 2013, meeting.

Board staff held a third meeting with interested parties on February 18, 2014, to discuss the revised draft of proposed Regulation 1525.4. At the meeting, staff responded to written comments received prior to the December 5, 2013, meeting, and agreed to address other suggestions to clarify how tax applies when a purchaser has a qualifying four digit NAICS industry group code (but not a six digit code); further clarify the phrase "primarily engaged"; and add additional tests to ascertain if a purchaser is primarily engaged in a qualifying activity. At the meeting, staff also received suggestions to provide that a qualified person may include an otherwise qualified "establishment" in an apportioning trade or business, subject to RTC section 6377.1, subdivision (b)(6)(B), and businesses that do not have a qualifying six or four digit NAICS code described in RTC section 6377.1, subdivision (b)(6)(A). However, staff did not agree to incorporate these suggestions into the proposed regulation because they are precluded by the express language of RTC section 6377.1.

Therefore, Board staff subsequently prepared Formal Issue Paper 14-001, which recommended that the Board adopt staff's revised draft of proposed Regulation 1525.4 to implement, interpret, and make specific the provisions of RTC section 6377.1. Specifically, subdivision (a) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (a)(1) through (4), prescribing the types of transactions that qualify for the new partial exemption, identified the specific sales and use taxes the partial exemption provided by RTC section 6377.1 does and does not apply to, and provided notice of the partial exemption rates from July 1, 2014, to December 31, 2016, and January 1, 2017, to June 30, 2022.

Subdivision (b) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definitions of "fabricating," "primarily," and "processing" verbatim from RTC section 6377.1, subdivision (b)(1), (3), and (5). Subdivision (b) incorporated the statutory definition of "manufacturing" from RTC section 6377.1, subdivision (b)(2), and clarified when tangible personal property will be treated as having a greater service life or greater functionality for purposes of that definition, using language borrowed from Regulation 1525.2, subdivision (c)(10)(B), and Regulation 1525.2, subdivision (c)(2), respectively. Subdivision (b) defined "packaging" as used in RTC section 6377.1, subdivision (a)(1) and (b)(4) based, in part, on the definition of "packaging" in Regulation 1525.2, subdivision (a)(1)(B). Subdivision (b) defined "pollution control" as used in RTC section 6377.1, subdivision (b)(7)(A)(iii), and clarified that an activity is a pollution control activity to the extent it meets or *exceeds* pollution control standards established by the state or any local or regional governmental agency within the state consistent with RTC section 6377, subdivision (b)(11)(C) and Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) incorporated the statutory definition of "process" from RTC section 6377.1, subdivision (b)(6), and clarified that the term "process" includes the activity of testing products for quality assurance before they are altered to their completed form, as referred to in RTC section 6377.1, subdivision (a)(3).

Subdivision (b) defined “recycling” and “refining” as used in RTC section 6377.1, subdivisions (a)(1) and (4), and (b)(4). Subdivision (b) incorporated the definition of “research and development” from RTC section 6377.1, subdivision (b)(9), and clarified the definition by incorporating provisions from 26 Code of Federal Regulation part 1.174-2, subdivision (a), which defines the term “research and development” for purposes of Internal Revenue Code section 174. And, subdivision (b) implemented the definition of “useful life” provided by RTC section 6377.1, subdivision (b)(10), by explaining when property is and is not treated as having a useful life of one or more years for state income or franchise tax purposes using language borrowed from Regulation 1525.2, subdivision (c)(9)(B) and (10)(B).

Subdivision (b)(8) of the revised draft of proposed Regulation 1525.4 incorporated the definition of “qualified person” from RTC section 6377.1, subdivision (b)(6). Subdivision (b)(8) also:

- Provided a definition for the term “primarily engaged,” as used in RTC section 6377.1, subdivision (b)(6);
- Clarified that “primarily engaged” is intended to have a similar meaning to “primarily engaged” as used in RTC section 6378, as interpreted by Regulation 1532, subdivision (c)(2) (the definition of “primarily” in RTC section 6377.1, subdivision (b)(3), is intended to have the same meaning as the definition of “primarily” in RTC section 6378, subdivision (c)(1) and therefore does not apply to “primarily engaged”);
- Clarified that a qualified person may be primarily engaged in a qualifying activity or activities described in RTC section 6377.1, subdivision (a), either as a “legal entity” (meaning a “person” as defined in RTC, § 6005) or as an “establishment,” similar to Regulation 1525.2, subdivision (c)(6)(B), and Regulation 1532, subdivision (c)(2);
- Defined the term “establishment” in a manner that is similar to Regulation 1525.2, subdivision (c)(6)(B);
- Generally incorporated the “gross revenue” test for determining when a qualified person is “primarily engaged” and the “funds allocated” test for determining when a nonprofit is “primarily engaged” from Regulation 1532, subdivision (c)(2), and, based upon input from interested parties, added “operating expense” tests for legal entities and establishments;
- Provided an alternative “value of production” test for determining when an establishment is “primarily engaged” that is similar to the “value of production” test in Regulation 1525.2, subdivision (c)(6)(B), and, based upon input from interested parties, also provided an alternative “employee salaries and wages” test for establishments;
- Clarified the reference to RTC section 25128 in RTC section 6377.1, subdivision (b)(6)(B), by generally describing the trades or businesses that are subject to the provisions of section 25128.

Subdivision (b)(9) of the revised draft of proposed Regulation 1525.4 incorporated the statutory definition of “qualified tangible personal property” from RTC section 6377.1, subdivision (a)(7). Subdivision (b) clarified when manufacturing aids are considered "qualified tangible personal property," and clarified that qualified tangible personal property includes tangible personal property used in pollution control that *exceeds* pollution control standards established by this state or any local or regional governmental agency within this state consistent with Regulation 1525.2, subdivision (c)(10)(C). Subdivision (b) further defined and clarified the meaning of "special purpose buildings and foundations" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(A)(iv), using language borrowed from RTC section 6377, subdivision (b)(11)(D), and Regulation 1525.2, subdivision (c)(10)(D)1-6, and clarified when the partial exemption does and does not apply to transactions involving special purpose buildings and foundations. And, subdivision (b) provided that the "extraction processes" as used in the definition of qualified property in RTC section 6377.1, subdivision (a)(7)(B)(ii), includes such severance activities as mining, oil and gas extraction, as was also provided in Regulation 1525.2, subdivision (c)(9)(C).

Subdivision (c) of the revised draft of proposed Regulation 1525.4 prescribed the form of the partial exemption certificate that the purchaser is statutorily required to furnish to the retailer under RTC section 6377.1, allowed for the issuance of a blanket partial exemption certificate to cover multiple purchases from the same vendor, and prescribed the circumstances under which a retailer may accept such a partial exemption certificate in good faith for purposes of relieving the retailer of liability for the sales tax or the duty of collecting the use tax from the purchaser, similar to Regulation 1532, subdivision (e). Subdivision (c) also provides that qualified purchasers may use the sample partial exemption certificate set forth in appendix A, and construction contractors may use the sample partial exemption certificate in appendix B.

Subdivision (d) of the revised draft of proposed Regulation 1525.4 generally incorporated the provisions of RTC section 6377.1, subdivision (e)(1), establishing the $200 million cap and providing that the exemption does not apply to property under specified circumstances, and clarified how the "calendar year" test in subdivision (e)(1)(A) applies when the partial exemption is only effective for part of a calendar year. Subdivision (e) of the revised draft of proposed Regulation 1525.4 incorporated the provisions of RTC section 6377.1, subdivision (e)(2), prescribing the circumstances under which a purchaser is liable for sales tax.

Subdivision (f) of the revised draft of proposed Regulation 1525.4 clarified the application of the partial exemption provided by RTC section 6377.1 to lease transactions. Subdivision (f) specifically explained when rentals payable will be subject to the partial exemption in circumstances where a lease was entered into prior to the operative date of RTC section 6377.1, for a lease term expiring after the operative date, in a similar manner as Regulation 1532, subdivision (i)(1), clarified the application of the partial exemption provided by RTC section 6378 to the same circumstances. Subdivision (f) also specified how the one-year test period (for purposes of ascertaining the primary use of property) applies in the context of lease transactions.

Subdivision (g) of the revised draft of proposed Regulation 1525.4 clarified that Regulation 1521, *Construction Contractors*, still provides for the basic application of tax to construction contractors. Subdivision (g)(1) explained that a construction contractor performing a construction contract described in RTC section 6377.1, subdivision (a)(4), should obtain a partial exemption certificate (in the form shown in appendix A) from the qualified person, and a construction contractor, purchasing property from a retailer in this state or engaged in business in this state, for use in a qualified construction contract, must timely furnish its own partial exemption certificate to the retailer (in the form shown in appendix B). Subdivision (g)(2) clarified that a construction contractor may independently qualify as a "qualified person" for purposes of the partial exemption. And, subdivision (g)(3) clarified how the $200 million cap applies to fixtures and materials sold or use in the construction of special purposes buildings and foundations.

Finally, subdivision (h) of the revised draft of proposed Regulation 1525.4 clarified that purchasers of qualified tangible personal property may file claims for refund with the Board regarding use tax transactions because consumers are directly liable for use tax. However, only retailers may file claims for refund with the Board regarding sales tax transactions because sales tax is directly imposed on and paid by retailers. Subdivision (h) also provides additional notice that claims for refund of sales and use tax must be timely filed in accordance with RTC section 6902.

Furthermore, Formal Issue Paper 14-001 informed the Board that Board staff and the interested parties had agreed to the provisions of the revised draft of Regulation 1525.4 attached to the issue, except for the following three items:

1. Waste Management's recommendation to include a specific example in subdivision (b)(8)(A) of the regulation explaining when a business in the recycling industry is a "qualified person";
2. The California Taxpayers Association's (CalTax's) recommendation to include alternative tests in subdivision (b)(8)(A)1 to provide that an establishment may be "primarily engaged" based on number of employees, employee hours, number of units produced, or capital investment; and
3. The California Poultry Federation's recommendation that the regulation clarify that the "establishment" concept can apply so that a person with a qualifying establishment can be a "qualified person" for purposes of that establishment, even if the person is otherwise an apportioning trade or business that would be precluded from the definition of qualified person by RTC section 6377.1, subdivision (b)(6)(B).

Business Taxes Committee Meeting

The Board considered Formal Issue Paper 14-001 during its Business Taxes Committee meeting on April 22, 2014. During the meeting, the Board heard public comments from Ms. Therese Twomey, CalTax's Fiscal Policy Director, Mr. Joe Vinatieri from Bewley, Lassleben, & Miller LLP, Ms. Nicole Rice, the California Manufacturers & Technology Association's Policy Director, Mr. Bill Mattos, President of the California Poultry

Federation, Mr. Brian Grant, Foster Farms' Tax Director, Mr. Chuck White, Director of Regulatory Affairs for the Department of Waste Management, Mr. Ralph Chandler, Regulatory Affairs Director for the California Refuse and Recycling Coalition, and Mr. Ken Dunham, Executive Director of the West Coast Lumber & Building Material Association. (See the transcript or video for more detail.) The Board also discussed the proposed regulation with Board staff.

During the Business Taxes Committee meeting, the Board also agreed with staff's recommendation to propose to adopt staff's revised draft of Regulation 1525.4, subject to two additional clarifications. First, the Board agreed with CalTax's recommendation to include an alternative test in subdivision (b)(8)(A)1 of the regulation to provide that an establishment may be primarily engaged based on "number of employees" with the condition that the number of employees be "based upon a full-time equivalency." Second, in response to Waste Management's recommendation, the Board agreed to add an example to subdivision (b)(8)(A), to provide that a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are "reasonably" described in a qualifying four digit NAICS industry group. The Board Members unanimously voted to propose the adoption of the regulation, with the two clarifications noted above.

The Board determined that the adoption of the regulation is reasonably necessary for the specific purposes of implementing, interpreting, and making specific the provisions of RTC section 6377.1, prescribing the form of the partial exemption certificates that must be issued to retailers to claim the new partial exemption, and addressing all of the issues (or problems) identified above. The Board further determined that the regulation is reasonably necessary for the specific purposes of clarifying when a purchaser is primarily engaged in a qualifying line of business, and when a person is or is not a qualified person.

The Board anticipates that the adoption of proposed Regulation 1525.4 will benefit the Board, Board staff, and persons engaged in manufacturing, research and development, or both by:

- Providing guidance about and promoting awareness of the partial exemption for equipment used primarily in manufacturing and research and development provided by RTC 6377.1, and the requirements to qualify for the partial exemption;
- Implementing RTC section 6377.1, subdivision (c) by prescribing the form of the partial exemption certificate that qualified persons and construction contractors must issue to retailers, and providing sample partial exemption certificates that meets the required form for such persons to use;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(6)(A) by defining what is meant by the requirement that a qualified purchaser be "primarily engaged" in a qualifying line of business;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(7)(A)(iv) by further defining "special purpose buildings and foundations";

- Interpreting and making specific RTC section 6377.1, subdivision (f) by clarifying the application of the partial exemption in the context of certain lease transactions; and
- Interpreting and making specific RTC section 6377.1, subdivision (a)(4) by clarifying the application of the partial exemption to transactions involving construction contracts.

The adoption of proposed Regulation 1525.4 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to proposed Regulation 1525.4.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 14-001, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its April 22, 2014, Business Taxes Committee meeting in deciding to propose the adoption of Regulation 1525.4, described above.

ALTERNATIVES CONSIDERED

The Board considered whether to propose to adopt Regulation 1525.4 as recommended by staff in Formal Issue Paper 14-001 during its April 22, 2014, Business Taxes Committee meeting. In addition, the Board considered two reasonable alternatives to proposed Regulation 1525.4, where Board staff and interested parties had different proposed language.

First, RTC section 6377.1, subdivision (b)(6)(A) provides that the term qualified person means a person that is primarily engaged in those lines of business described in NAICS codes 3111 to 3399, inclusive, 541711, or 541712. Board staff suggested that proposed Regulation 1525.4, subdivision (b)(8)(A), clarify that a person may be a qualified person even if there is no applicable six digit NAICS code to describe the person's line of business, provided that their business activities are described in a qualified four digit industry group, without providing any examples. Waste Management suggested alternative language that added an example further clarifying that "the recycling industry will not be precluded from the definition of a '[q]ualified person' for not having a specific four or six digit NAICS code, provided that their activities and/or products are described in a qualified [four] digit [NAICS] industry group." (See Exhibit 4 to Formal Issue Paper 14-001.) After considering the proposed example, the Board (1) revised staff's suggested language to clarify that the business activity must be "reasonably" described in a qualified four digit industry group; (2) included a revised example in subdivision (b)(8)(A) of the proposed regulation, which clarifies that "a business in the recycling industry may be regarded as a qualified person when the activities of the establishment are reasonably described in a qualified four digit industry group"; and (3) excluded the reference to "products" from the example.

Second, as explained more fully above, the definition of "qualified person" in RTC section 6377.1, subdivision (b)(6)(A), uses the phrase "primarily engaged," and existing law does not specifically define what is meant by "primarily engaged" for purposes of RTC section 6377.1. Board staff suggested that proposed Regulation 1525.4, subdivision (b)(8)(A)(1), include alternative tests to ascertain if an establishment is primarily engaged in a qualifying line of business based on: (1) gross revenue; (2) operating expenses; (3) employee salaries and wages; or (4) value of production. CalTax suggested alternative language adding, in addition to the tests noted above; (5) number of employees; (6) employee hours; (7) number of units produced; or (8) capital investment. (See Exhibit 3 to Formal Issue Paper 14-001.) After considering whether staff's language excluded persons from the definition of "qualified person" that should qualify for the partial exemption, the Board added one additional test for primarily engaged based on "number of employees," but further clarified that the additional test is "based on full time equivalency."

Furthermore, the California Poultry Federation's suggested that Regulation 1525.4 clarify that the "establishment" concept can apply so that a person with a qualifying establishment can be a "qualified person" for purposes of that establishment, even if the person is otherwise an apportioning trade or business that would be precluded from the definition of qualified person by RTC section 6377.1, subdivision (b)(6)(B). In Formal Issue Paper 14-001, Board staff concluded that the provisions in RTC section 6377.1, subdivision (b)(6)(B) are specific and would not allow staff to apply the establishment concept as suggested by the California Poultry Federation. After considering the California Poultry Federation's suggestion during the April 22, 2014, Business Taxes Committee meeting, several Board Members recommended that the California Poultry Federation seek an amendment to RTC section 6377.1 that would fix the issue identified by staff, and the Board did not make any changes to staff's recommended language for Regulation 1525.4 in response to this suggestion.

During the Board's April 22, 2014, Business Taxes Committee meeting, the Board decided to propose to adopt Regulation 1525.4 as recommended by staff and with the two changes noted above because the Board determined that the adoption of the proposed regulation is reasonably necessary for all the reasons provided above. The Board did not reject any reasonable alternative to proposed Regulation 1525.4 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)(1)

AB 93, as amended by SB 90, added section 6377.1 to the RTC effective July 11, 2013. Section 1 of AB 93 specifies that it is the intent of the Legislature in adding RTC section 6377.1 to exempt manufacturing equipment from state sales and use taxes in order to make California more competitive in attracting new businesses to this state. And, the Board anticipates that RTC section 6377.1 will have some economic impact on business and state revenue.

The Board is proposing to adopt Regulation 1525.4 to implement, interpret, and make specific the provisions of RTC section 6377.1, define and further define statutory terms, including "qualified person," explain when the partial exemption does and does not apply, prescribe the form of the partial exemption certificate that must be provided to the retailer pursuant to RTC section 6377.1, subdivision (c), and provide sample partial exemption certificates to be used for claiming the partial exemption,. In addition, the Board intends to make the sample partial exemption certificates set forth in Appendices A and B to proposed Regulation 1525.4 available to the public on the Board's website.

The Board anticipates that the adoption of proposed Regulation 1525.4 will benefit the Board, Board staff, and persons engaged in manufacturing, research and development, or both by:

- Providing guidance about and promoting awareness of the partial exemption for equipment used primarily in manufacturing and research and development provided by RTC 6377.1, and the requirements to qualify for the partial exemption;
- Implementing RTC section 6377.1, subdivision (c) by prescribing the form of the partial exemption certificate that qualified persons and construction contractors must issue to retailers, and providing sample partial exemption certificates that meets the required form for such persons to use;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(6)(A) by defining what is meant by the requirement that a qualified purchaser be "primarily engaged" in a qualifying line of business;
- Interpreting and making specific RTC section 6377.1, subdivision (b)(7)(A)(iv) by further defining "special purpose buildings and foundations";
- Interpreting and making specific RTC section 6377.1, subdivision (f) by clarifying the application of the partial exemption in the context of certain lease transactions; and
- Interpreting and making specific RTC section 6377.1, subdivision (a)(4) by clarifying the application of the partial exemption to transactions involving construction contracts.

All of the provisions in proposed Regulation 1525.4 are fully consistent with current law, including RTC section 6377.1, and there is nothing in proposed Regulation 1525.4 that would significantly change how individuals and businesses would generally behave in response to RTC section 6377.1 in the absence of the proposed regulatory action. Therefore, the Board estimates that the proposed regulation will not have a measurable economic impact on individuals and business that is in addition to whatever economic impact RTC section 6377.1 will have on individuals and businesses. And, the Board has determined that the proposed adoption of Regulation 1525.4 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed regulation will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars ($50,000,000) during any 12-month period.

In addition, the Board has determined that proposed Regulation 1525.4 does not impose any costs on any persons, including businesses, which are not already imposed by RTC section 6377.1, and the Board has determined that there is nothing in proposed Regulation 1525.4 that would impact revenue. Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of proposed Regulation 1525.4 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, proposed Regulation 1525.4 will not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of proposed Regulation 1525.4 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of proposed Regulation 1525.4 will not have a significant adverse economic impact on business.

The adoption of proposed Regulation 1525.4 may affect small businesses.